EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2015 and 2016

Autumn 2015

About the European Forecasting Network

The European Forecasting Network (EFN) is a research group of European institutions, founded in 2001 under the auspices of the European Commission, and currently partly financially supported by the Schuman Centre at the European University Institute. The objective of the EFN is to provide a critical analysis of the current economic situation in the euro area, short-term forecasts of the main macroeconomic and financial variables, policy advice, and in-depth study of topics of particular relevance for the working of the European Economic and Monetary Union. The EFN publishes four quarterly reports. Further information on the EFN can be obtained from our web site, http://www.eui.eu/Projects/EFN/Home.aspx.

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Highlights

- For the end of this year and for 2016, chances are good that production in advanced economies will continue to expand a bit faster than at trend rates, while growth dynamics in emerging markets economies will not strengthen or even continue to decrease.
- Since autumn 2014, production in the euro area expands at an annualized rate of about 1.5%. The recovery appears to be broad based, with contributions from private consumption, exports, and investment into fixed capital, although it fell back in the second quarter after a strong increase at the beginning of the year. From a regional perspective, the recovery is as well quite broad based: production is expanding in almost every country, surprisingly and according to official data, including Greece.
- Structural impediments still limit the ability of the euro area economy to grow strongly: firms and, in particular, private households are only slowly reducing their heavy debt burdens.
- According to our forecasts, the euro area GDP will grow by 1.6% in 2015 and by 1.9% in 2016. The high increase in the number of refugees in 2015 will, in principle, positively affect private as well as public consumption, but the effect should be below 0.1 percentage points relative to GDP.
- Our inflation forecast for 2015 is 0.1%. For 2016, we expect that inflation will increase to 1.3%, which is still below the ECB’s target of 2%.

Table 1 Economic outlook for the Euro area

	2012	2013	2014	2015: 2nd half		2015: annual		2016: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	-0.8	-0.3	0.9	1.9	1.4 2.4	1.6	1.4 1.9	1.9	1.0 2.7
Potential Output	-0.2	-0.2	0.8	0.9	0.6 1.2	1.0	0.9 1.2	0.8	0.3 1.2
Private Consumption	-1.2	-0.7	0.9	1.8	1.4 2.2	1.8	1.6 2.0	1.5	0.7 2.3
Government Consumption	-0.1	0.2	0.8	1.1	0.7 1.5	1.2	1.0 1.4	0.5	-0.1 1.1
Fixed Capital Formation	-3.6	-2.6	1.2	4.1	2.3 6.0	2.9	2.0 3.9	4.1	1.8 6.5
Exports	2.7	2.0	3.9	4.6	4.1 5.1	5.3	4.8 5.9	5.8	4.2 7.5
Imports	-0.9	1.3	4.2	6.4	5.0 7.7	5.8	5.1 6.5	6.4	4.4 8.4
Unemployment Rate	11.4	12.0	11.6	10.8	10.6 11.0	11.0	10.9 11.1	10.4	9.9 10.9
Labour Cost Index	2.4	1.2	1.2	2.0	1.6 2.4	1.9	1.7 2.1	2.3	1.8 2.8
Labour Productivity	-0.3	0.4	0.3	0.9	0.5 1.4	0.8	0.5 1.0	1.0	0.3 1.7
HICP	2.5	1.3	0.4	0.2	0.4 -0.0	0.1	0.2 -0.1	1.3	2.2 0.4
IPI	-2.5	-0.7	0.9	2.1	4.1 0.1	1.9	3.0 0.8	1.8	4.0 -0.4

Percentage change in the average level compared with the same period a year earlier, except for the output gap that is the deviation of actual GDP from potential GDP as a per cent of potential GDP and except for the unemployment rate. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

Economic Outlook for 2015 and 2016

The world economy: suffering from emerging markets instability

In autumn 2015, the image of the world economy is split in two halves: on the one hand, production in most advanced economies expands at quite healthy rates, with upswings in the US and the UK and a moderate recovery in the euro area continuing. On the other hand, economic conditions have deteriorated in many emerging markets economies, in China already at the beginning of the year. Weak Chinese imports are the main cause for a decrease in world trade in the first half of 2015, and they have adversely affected other East Asian economies, including Japan. In addition, many exporters of crude oil and other commodities suffer from prices that fell markedly in the second half of last year. Russia and Brazil, each struggling with its own political headwinds, are in deep recessions. In the summer, turmoil on international markets for capital and commodities has further worsened the conditions for many emerging markets economies.

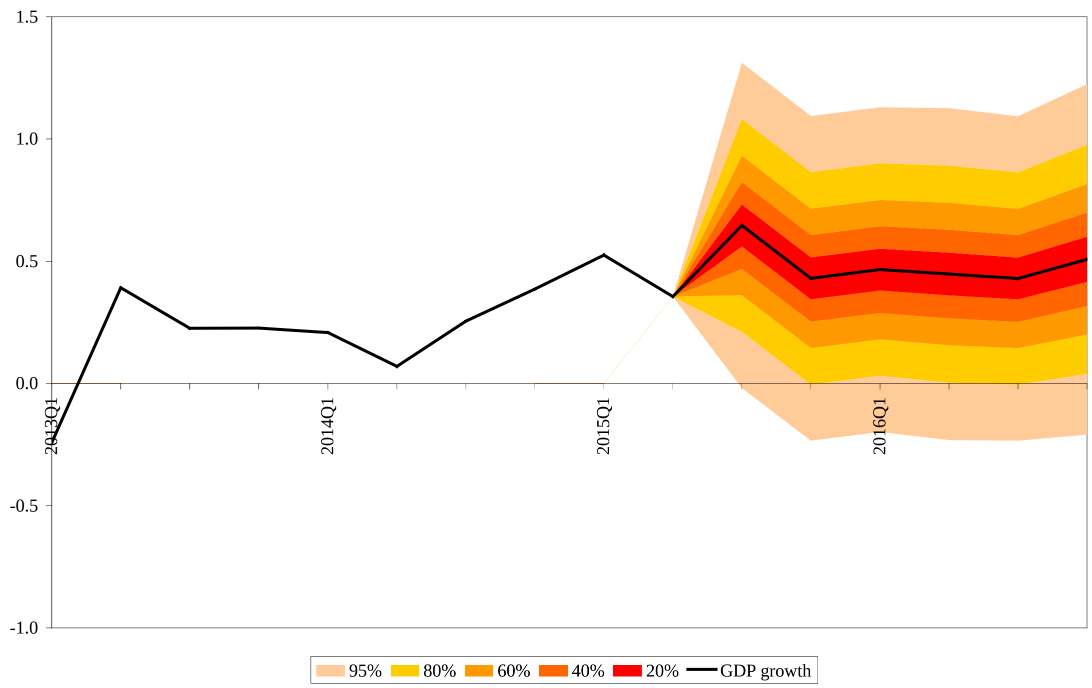
The turmoil started in China, where authorities tightened rules on stock trading in June, which made a stock price bubble burst. The Chinese government reacted with measures, such as artificially propping up demand for stocks, which were not helpful for recovering confidence in the smooth functioning of Chinese financial markets. The central bank allowed a depreciation of the renminbi by 4.5% relative to the US dollar. In August, worldwide stock prices fell markedly, and indicators for volatility increased, apparently caused by growing concerns about the health of the Chinese economy. Investors sold currencies and assets of those economies that particularly rely on demand from China or that depend on exports of commodities, because prices for oil and industrial raw materials decreased again markedly.

Most advanced economies as well as many East Asian emerging markets economies benefit from low energy prices, while, of course, energy exporters suffer. The net effect on demand should not add up to zero, but should be moderately positive, as oil producers on average save more of their income, accumulating current account surpluses, while the reverse is true for net importers. Thus, a shift of income from the former to the latter group should increase demand for the importers by more than it reduces demand of exporters, supporting overall production. For the end of this year and for 2016, chances are good that production in advanced economies will continue to expand a bit faster than at trend rates, while growth dynamics in emerging markets economies will not strengthen or even continue to decrease. The main risk for the world economy is that movements on financial markets might destabilize commodity-exporting economies. At present, in addition to low commodity prices, a second motive for pulling capital out of emerging markets is the expectation of higher yields in advanced economies, since the Fed will probably start raising interest rates at the end of 2015.

Recovery in the euro area continues

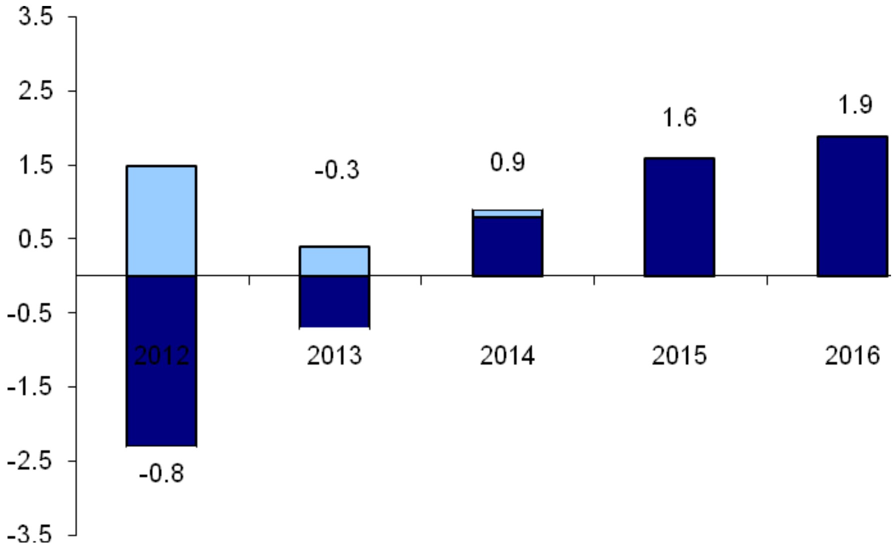
Since autumn 2014, production in the euro area expands at annualized rate of about 1.5%. The recovery appears to be broad based, with contributions from private consumption, exports, and investment into fixed capital. In the second quarter, however, investment in construction fell back, after a strong increase at the beginning of the year, while export demand was high. From a regional perspective, the recovery is as well quite broad based: production is expanding in almost every country, surprisingly and according to official data including Greece. In France, however, production was stagnant in the second quarter, and the recession of the French construction sector continued. France is the only larger euro area economy where the unemployment rate is still not decreasing. In the monetary union in general, however, the rate has been slowly going down since summer 2013, from about 12% to 11% in July, and employment has been expanding by about 1% per year if calculated in hours worked, and by a bit less for the number of persons employed. Wages have been increasing by about 1.5% per annum in nominal terms since 2013, and since autumn of 2014, when energy prices started dragging down consumer price inflation, real wages go up.

Figure 1 Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter

Figure 2 Contributions of domestic components and net exports to GDP growth



Domestic demand dark, net exports light area. Percentage points, figures above or below the columns indicate overall GDP growth

The sentiment indicators point to a continuation of the recovery: according to the indicators of the European Commission, confidence has, from quite a high level, recently further increased. The main factors supporting and weakening the recovery have also not changed by much since the beginning of the year: financial conditions are about neutral in the euro area both this year and in 2016. Monetary conditions should support growth. Governments and large corporations benefit from bond yields that are still very low, although they rose a bit early in the summer due to fading fears of deflation, and interest rates of bank credit have been falling further in 2015.

ECB's quantitative expansion seems to have played a role on inflation expectation. The probability of one-year-ahead inflation to be above 1.5%, which can be considered as a threshold similar to "close to but less than 2%", has risen since March to 40% on average. Compared to the 30% with a decreasing trend observed during 2014, this represents a change to the better. At the same time, the current probability of 40% does not seem to support important changes in monetary policy, at least in the near future.

Figure 3 Economic Sentiment Indicator and confidence bands

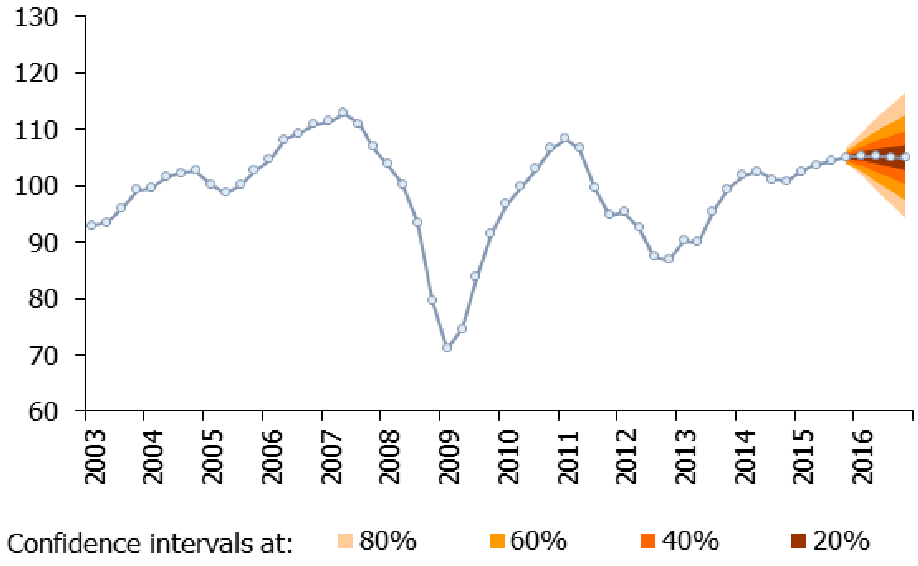
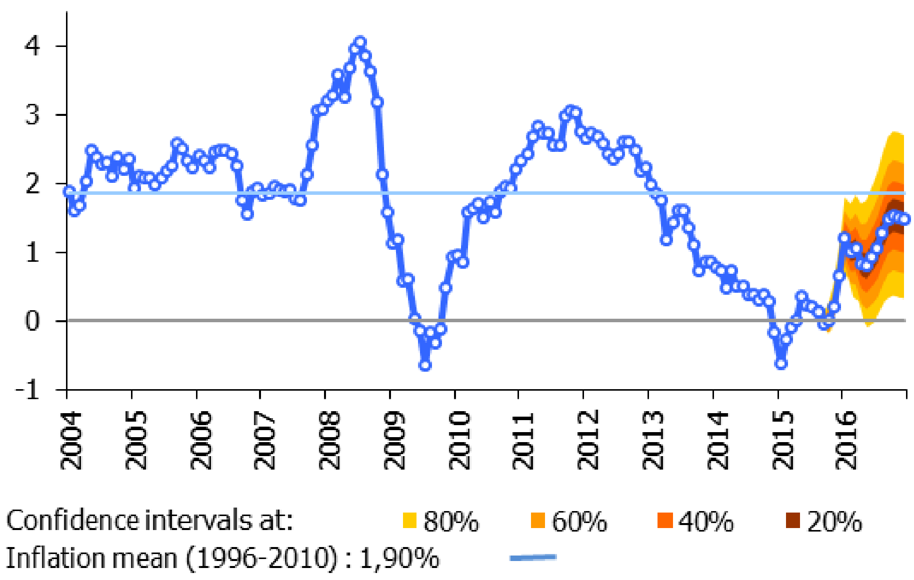


Figure 4 HICP and confidence bands



The volume of new loans, whether for private households or for nonfinancial corporations, has only stopped shrinking. Clearly, this recovery is not yet investment-driven, as capacity utilization in manufacturing is still just about average. Instead, the rise in real disposable incomes due to the repeated falls in oil prices will continue to push private consumption.

The high increase in the number of refugees in 2015 will, in principle, positively affect private as well as public consumption, but the effect should be below 0.1 percentage points relative to GDP. Much more important is that, although the euro stopped depreciating in spring 2015, production in the euro area has become more competitive due to the euro's fall in the twelve months before, and exports will continue to benefit from this tailwind. However, structural impediments still limit the ability of the euro area economy to grow strongly: firms and, in particular, private households are only slowly reducing their heavy debt burdens. Reforms are still only half-way through in Italy and in France. All in all, the euro area economy is forecast to grow by 1.6% in 2015 and by 1.9% in 2016, as the negative factors slowly become less important.

Figure 5 Probability of the inflation in the Euro Area to be above 1.5% one year after the month of reference

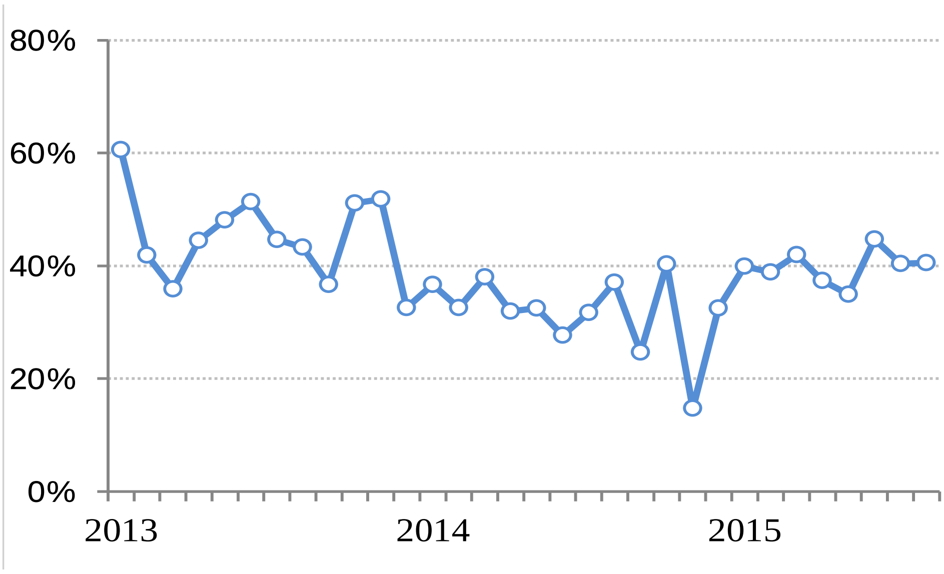


Table 2 Annual average rates for industrial production in the euro area

	2011	2012	2013	2014	2015	2016
Durable	0.8	-4.7	-3.2	-0.6	1.2	1.4
Non Durable	0.9	-2.2	0.0	3.1	1.7	2.2
Capital	8.4	-1.0	-0.6	1.8	2.6	3.5
Intermediate	4.2	-4.4	-1.0	1.2	0.7	1.0
Energy	-4.4	-0.1	-0.8	-5.5	2.0	-0.7
Total	3.5	-2.5	-0.7	0.9	1.9	1.8

Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconometric model, described in detail in the EFN Spring 2002 report. Table 3 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with other forecasts, notably those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics.

The EFN forecast is relatively optimistic, because we think that the steep fall in the oil price and the weaker euro will stimulate the economy. In 2016, growth accelerates according to the EFN forecast in spite of slower growth in private consumption, because firms will invest more in fixed capital and rebuild inventories that currently stay at very low levels.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF*		ECB		OECD		Consensus	
	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016
GDP	1.6	1.9	1.5	1.9	1.5	1.6	1.4	1.8	1.4	2.1	1.4	1.7
Priv. Consumption	1.8	1.5	1.8	1.6	1.7	1.5	1.7	1.7	1.0	1.3	1.7	1.6
Gov. Consumption	1.2	0.5	0.6	0.8	0.7	0.5	0.7	0.8	0.4	0.6	1.1	0.7
Fixed Capital Form.	2.9	4.1	1.7	4.0	1.5	2.4	2.1	3.4	1.2	3.1	1.7	2.9
Unemployment rate	11.0	10.4	11.0	10.5	11.1	10.6	11.0	10.6	11.1	10.5	11.1	10.6
HICP	0.1	1.3	0.1	1.5	0.1	1.0	0.1	1.1	0.0	1.3	0.2	1.2
IP	1.9	1.8	na	na	na	na	na	na	na	na	1.7	2.1

EU: European Commission, Economic Forecast, May 2015; IMF: World Economic Outlook, April 2015; ECB: September 2015 eurosystem staff macroeconomic projections for the euro area, OECD: Economic Outlook, June 2015; Consensus: Consensus Economics Inc., Consensus Forecasts, September 2015.

*IMF World Economic Outlook, July 2015: GDP 2015 1.5%, 2016 1.7%.

Variables of the world economy

Assumptions concerning the evolution of important variables related to the state of the world economy are shown in Table 4 below. Oil prices, after they collapsed again during this summer, are assumed to rise again, but only moderately. Growth in world trade has been declining for the first half of this year, and a strong recovery is not in sight. We think that the elasticity between production growth and trade growth in the world has substantially gone down since about 2011.

Table 4 Variables of the world economy

	2014	2015	2016
US GDP Growth Rate	2.4	2.5	2.7
US Consumer Price Inflation	1.6	0.2	1.9
US Short Term Interest Rate (December)	0.03	0.4	1.4
US Long Term Interest Rate (December)	2.2	2.5	3.2
Japan GDP Growth Rate	-0.1	0.7	1.5
Japan Consumer Price Inflation	2.7	0.7	0.8
Japan Short Term Interest Rate (December)	0.1	0.2	0.2
Japan Long Term Interest Rate (December)	0.5	0.5	0.7
World Trade Growth Rate	3.5	1.6	2.0
Oil Price (December)	63	52.4	56.2
USD/Euro Exchange Rate (December)	1.21	1.12	1.12
100Yen/Euro Exchange Rate (December)	1.43	1.36	1.36

Apart from the development of world trade, long-term interest rates and nominal exchange rates, all variables are exogenous to the EFN forecast, mostly close to those of Consensus Economics (2014). The oil price is in US dollar per barrel (Brent). US short term interest rate: 3-month treasury bills. US long term interest rates: 10-year treasury bills. Japan short term interest rate: 3-month deposits (LIBOR). Japan long term interest rates: 10-year treasury bills.